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FREQUENT FLYER PROGRAMMES IN THE EU: COMPETITION ISSUES AND REGULATORY FRAMEWORK

Susanne Storm and Jesper Fredborg Larsen

Many of us belong to Frequent Flyer Programmes, possibly two or three. Can we say, hand on heart, that our membership has never influenced our choice of airline or choice of route or date of departure? If so, then clearly they are failing for that is just what they are intended to achieve. In practice they do have such an effect and as individuals we are all happy to benefit from the advantages they offer - but are our employers equally happy and do such programmes in fact act to our overall disadvantage by reducing choice and increasing prices? In this article by two Danish academics the economic and legal background to FFPs is discussed and the evidence of the anti-competitive effects of FFPs is examined.

1. Introduction. World Regulation of Air Transport

International air transport is a highly complex area. It is also of great commercial importance and in its origin closely connected with the nations of the world. Air transport for commercial purposes first became important after World War II. It was a matter of prestige for each State to have its own national airline - which was significantly called the "flagcarrier" of that State. British Airways, KLM, Lufthansa, Iberia, Air France and SAS are examples. Every State maintained complete sovereignty over the airspace of its own territory. This principle somehow had to be regulated, if commercial air transport were to become feasible. The 1944 Chicago Convention, to which 52 countries in the world adhere, together with two international agreements adopted that same year, did this. An international, multilateral scheme was established under these agreements but only for the very limited traffic rights of overflight without landing and stops for refuelling purposes. The more commercially significant traffic rights, namely the right to carry passengers and freight to and from another country, not to mention the right to fly

domestic routes in another country (cabotage), could not be agreed upon on a multilateral basis. These traffic rights are negotiated on a bilateral basis between two nations and the world is now spanned by a network of such bilateral "Air Service Agreements". They are and always have been highly restrictive and only national carriers from the two contracting States were allowed to operate between the two countries. Thus air transport became characterised by regulatory barriers to entry, market sharing and price fixing.

The US and European markets for air transport have always had different characteristics. Since the US is a large country, it has a market for domestic commercial air transport which has no equal in Europe. Nevertheless this internal market was made subject to tight Federal control from the beginning. It was not till the end of the 1970s and the beginning of the 1980s that the US market for air transport was liberalised. This deregulation also had its effects on air transport to and from the USA across the Atlantic, as the US adopted an "Open Skies" policy. This policy did not involve a departure from the bilateral agreements between the US and other countries, but it did mean that

more liberal bilateral agreements could be negotiated. Links were established between US airlines and European partners. The ultimate goal was and is that US companies would be able to fly domestic routes in Europe and vice versa.

The European Community has been and still is weakened by the fact that in relation to third countries and in certain areas, the Community has shared competencies with the Member States when completing international agreements. The Commission claims it should have sole powers to negotiate, but Member States do still enter into bilateral agreements, notably the "Open Skies" agreements with the US. At present the Commission has initiated proceedings in the European Court of Justice (ECJ) for breach of the Treaty against eight European countries who have concluded "Open Skies" agreements with the US.

This article has as its focus a limited aspect of the effect of deregulation on air transport, namely the effect of frequent flyer programmes (FFPs) on air transport markets. We will compare two economic models of the effects of FFPs on air transport markets with present EU competition practices under Articles 81 and 82. We hope that this analysis of FFPs and their effects on competition, particularly on the European market for air transport will help to throw some light on the liberalisation of air transport in the Community and its success.

In this article we will examine briefly the state of the deregulated market in the Community. In section 2 the internal market for air transport and in section 3 the characteristics of FFPs will be described as a background to the analysis. Section 4 contains an outline of the results of two economic models applied to FFPs and air transport. In section 5 we examine how and

according to which principles the Commission has dealt with the FFPs under the EU competition rules. The aim of the article is to answer the question whether or not present Commission practice with regard to the FFPs is backed up by economic theory and by observations of the functioning of the market for air transport (section 6). Finally our policy conclusions and suggestions for an approach to FFPs are presented in section 7.

2. The EU Internal Market for Air Transport

Following the failure of the 1944 Chicago Convention to establish a multilateral regime for air transport, the European governments set up their own regulatory systems for their fledgeling air transport industries with the basic aim of protecting their national flag carriers - mostly publicly owned - from competition. Over the years, a tight international network of bilateral air transport agreements concerning scheduled air transport has developed in Europe.

When the Treaty of Rome was signed in 1957, air (and sea) transport were excluded from the general transport policy provisions of the Treaty (Articles 74-84, now 70-80). Instead Article 84(2) provides that air transport policy measures shall be taken as and when the Council decides. The reason for this was that the original six Member States did not feel ready to include air (and sea) transport in the removal of the national barriers between their countries.

If the Member States were hesitant, the Council also was reluctant to use its powers under Article 84(2). This failure to act on the Council's part resulted in the European Parliament taking the Council to Court in 1983 under Article 175 (now 232). In 1985 the European Court of Justice held in favour of the European Parliament and a few

months after the Court's decision the Council finally presented its "Master Plan" concerning the implementation of an air transport policy. It became an object for the Council to achieve the internal market in the air transport sector in two ways: 1) By requiring the Member States to abolish their national barriers and to move from a bilateral to a multilateral system under Article 84(2) (now Art. (80(2)); 2) by applying the competition rules of Articles 85 and 86 (now 81 and 82) in order to eliminate the anti-competitive agreements between airline companies. In 1986 in the *Nouvelles Frontières* case, the ECJ was asked for a preliminary ruling concerning fares below the tariffs agreed upon by IATA and approved by the French Ministry of Transport. The Court ruled that air transport was subject to the Treaty's provisions on competition even in the absence of implementing regulations. The Commission complied with the Court's ruling by proceeding against ten major European airlines for contravening Article 85 (now 81).

The process of liberalisation was carried out in three stages, each stage usually termed the first, the second and third package respectively. The first package was adopted by the Council in 1987, the second in 1990 and the third in June 1992. The third package coincided with the completion of the internal market.

Articles 85 and 86 were made applicable to international air transport between Member States as part of the first package in 1987. In April 1989 the ECJ delivered a judgement in the *Ahmed Saeed Flugreisen* case, which established that the competition rules apply also to domestic air transport and to air transport between Member States and third countries. The third package of 1992 extended the scope of application of the competition rules to domestic air transport within a Member State.

The Commission granted wide block exemptions in the area of air transport related services. These block exemptions have been updated continuously throughout the 1990s (Blanco and Houtte 1996, p. 169).

Summing up, the competition rules apply to air transport under three different regimes: 1) Articles 81 and 82 are fully applicable to all air transport within the Community; 2) "the interim regime" referred to in the *Nouvelles Frontières* case provided by Articles 84 and 85 (ex 88 and 89) applies to air transport between Member States and third countries; 3) the competition rules apply only to air transport as such. Any other activity in connection with air transport, for example ground handling, is governed by the ordinary competition rules.

The third package allowed free tariff-fixing as from 1st January 1993. Two policies can be distinguished in the European market: 1) The large, established airlines compete for market share by offering a great variety of discounted fares on selected flights during limited seasons and on a limited number of seats; 2) Smaller airlines – such as for example Ryanair and Virgin Express – with fewer routes and less flight frequency make use of the policy of offering discounted fares on all their flights.

Since April 1, 1997 there has been an internal market for air transport. In 1996, there were 518 routes within the Community of which 64 per cent were flown by airlines with monopoly, 30 per cent were duopolised and 6 per cent were flown by more than two airlines (in 1993, there were 488 routes, and the corresponding figures were 61 per cent, 37 per cent and 2 per cent). In 1996, 30 routes were served under the fifth freedom in the air compared with 14 in 1993 (COM (96)). The

market for air transport between Member States and third countries is still not liberalised due to the bilateral agreements.

In connection with the establishment of the internal market many European airlines in the EU followed a policy of total or partial privatisation. This was a result of reduced government involvement and liberalisation. The first airlines to be privatised were British Airways in the UK and KLM in the Netherlands. British Airways is the largest airline company in Europe and fully privately owned. SAS, Lufthansa and Swissair are part private and part publicly owned. Air France, Alitalia, Olympic Airways and Iberia are still fully publicly owned.

Following privatisation, practically all the European airlines have entered into partnership agreements. The Commission has two means of controlling such agreements, either by applying Article 81 or through the Merger Control Regulation. The purpose of partnership agreements is to create competitive advantages for the partners by complementing each others' services and by achieving economies of scale, while still keeping their independence. Most of the agreements made between the European airlines follow a pattern set by British Airways. The main alliances between airlines in Europe created links to airline companies in the rest of the world. The bigger airlines have several other, smaller, alliances with partners both inside and outside Europe. The third package helped to promote this type of agreement. Thus there were 59 alliances in 1990, 138 in 1994 and 171 in 1995 (COM (96)). These partnership agreements will be dealt with below in connection with the application of the competition rules to FFPs.

3. Frequent Flyer Programmes - History and Facts

The first frequent flyer programme, now called AAdvantage, was devised by American Airlines (AA) in 1981 as an attempt to create consumer loyalty in the newly deregulated US market. AA also sought to facilitate acceptance of the "hub and spoke system" which meant longer flight times as compared to direct flights. AA was so successful that all other major US carriers followed suit.

European carriers first participated in the schemes of US carriers and then developed their own programmes. In 1991 and 1992, most European carriers launched their own plans, but compared to their American counterparts they remained modest in size. In 1992 the AA scheme had 16 million members worldwide; BA: 186,000; KLM: 120,000; SAS: 70,000; Air France: 95,000; Iberia: 100,000; Swissair: 100,000 (Verchère 1993, p. 16). In 1997, AAdvantage had 28 million members worldwide compared to BA's 1 million members worldwide, SAS' 1 million, Air France's 1.3 million and Iberia's 450,000 members worldwide, (figures for the other airlines are not available for 1997, Verchère 1997, p. 31 - 36). Even though the European programmes cannot match their American counterparts as to membership figures, the number of European business travellers, who are members of the European schemes is high. Thus 86 per cent of European business travellers belong to an FFP. In each Member State the national airline's scheme is easily the most popular, but there are wide differences as to the degree of popularity. In the UK, 52 per cent preferred BA's FFP compared to 34 per cent in France preferring Air France's or 47 per cent in Germany preferring Lufthansa's (Drabbe 1996, p. 1).

An FFP is one of several marketing tools a carrier can use to develop customer loyalty. FFPs are designed in such a way as to encourage a passenger to choose a particular service even if its schedule is less convenient and/or its fares are less competitive as some US empirical surveys suggest to be the case, (Stephenson and Fox (1987) and (1993)). FFPs have been extended to travel related companies such as hotels, restaurants and car rental companies – even telephone companies – thus extending the network of loyalty.

The traveller participating in an FFP receives bonus points or miles for each flight. The number of points is either related to the distance travelled or to the destination's geographical zone. Some FFPs issue points only for full fare price tickets or for first and business class. In this respect SAS' EuroBonus programme is remarkable for also enabling travellers to gain bonus points on discounted fares. In the US, discounted fares generally entitle programme members to frequent flyer points. European FFPs are more targeted towards business travellers and quality linked compared with their US counter parts. On the whole, European schemes take more flying to accumulate sufficient points or miles to obtain an equivalent flight in comparison to US schemes.

All programmes are constructed so as to offer bonus points in a non-linear way. Thus, for travellers to accumulate points in several programmes is a waste of bonus points, as they will be unable to accumulate enough points to obtain a free bonus trip with any one of the airlines. In some cases airlines impose a time limit, before the expiry of which a minimum number of bonus points has to be accumulated, otherwise membership will be cancelled and the bonus points already credited to the participant cancelled also. In other cases airlines may require a

minimum number of flights during a certain period. Additionally, some airlines have introduced expiry or cut-off dates for bonus points already collected. Expiry dates serve to limit an airline's liabilities in terms of the accumulated stock of bonus points collected by its passengers.

4. Economic Modelling of FFPs and Competition between Airlines

Two papers explicitly explore the effect of FFPs on competition between airlines. Both papers see FFPs as increasing consumers' switching cost. Switching costs for the consumer are either 'natural costs' or 'costs created by companies' (artificial switching costs) both of which affect the consumer's choice between different suppliers. Natural switching costs for the consumer are typically transportation costs and uncertainty when gathering information about different suppliers' goods. Firms' created consumer switching costs correspond to benefits for the firm such as reputation, better quality, more favourable discounts than those offered by competitors as well as brand and firm loyalty.

The FFPs with their incorporation of a payoff system similar to normal quantity discounts aim to create artificial loyalty links between the consumer and the programme holding airline. This is done by creating artificial switching costs for the consumer by promising a discount on travels when becoming a member of the programme, on condition that the member flies more often with the programme holding airline than with its competitors.

The first paper by Cairns and Galbraith (1990) has as its focus almost entirely the behaviour of business travellers. Business travellers are characterised by making use of their principal-agent relationship (i.e. travelling on behalf of their employer) to maximise the benefits which they

derive from being members of a programme. The principal-agent problem arises because of the cost to the principal of monitoring the agent. Cairns and Galbraith model this relationship by assuming that agents only pay a fraction of the cost of their purchases and that monitoring costs are sufficiently high for the principal to place no restrictions on the agents' choice of supplier or level of supply. The airlines are modelled as having identical cost functions and allowed to have different networks. Costs are assumed to be separable across markets so that there are no economies of scope. They further assume that there are no network externalities. Markets are characterised by Bertrand competition.

The second paper is a working paper by Banerjee and Summers (1987), who assume that consumers have homogenous preferences. Thus, they do not distinguish between consumer segments, i.e. between business travellers and leisure travellers. They model competition between airlines in a game theoretic model with sequential price setting and simultaneous rebate size setting. Thus the model is made on the basis of two periods. During the first period travellers can maximise their benefit on the basis of the price they have to pay and on the basis of their expectancy of the price during the second period. Banerjee and Summers allow airlines to have identical cost functions. Their market is also characterised by Bertrand competition. The model examines the effect of FFPs on airline entry and exit, pricing and market structure.

Cairns and Galbraith find that the programmes increase the consumers' valuation of otherwise non-related products, or in the words of the two authors: The programmes create "artificial compatibility". Artificial compatibility means that it becomes advantageous to consumers to buy

from the same producer in situations where it would not otherwise have been so. This artificial compatibility is a result of saving bonus points when the consumers fly on the programme holder's routes, (but it is different from "bundling" where services or goods are sold jointly). The authors conclude that artificial compatibility influences consumers' choice of carrier. By creating such an artificial relationship between a programme-holding airline's own routes, the greater the network size, the better the airline is able to compete. The sheer number of routes possessed by the programme-holding airline becomes a comparative advantage in the presence of FFPs compared with carriers with smaller networks. Having a large network increases the services on offer to programme members and increases the number of available routes on which the FFP members can earn bonus points. In addition, the FFP-holding airline's services become incompatible with those of rivals, since bonus points obtained when flying with competitors can rarely be used elsewhere.

If a new entrant airline does not have the same network size as the incumbent, Cairns and Galbraith find that entry will not be possible. Their main argument is that the possession of a larger network enables the incumbent airline to offer its FFP members a better service than the entrant with a smaller network in terms of number of available destinations. To some extent the model even allows for entrants to be more cost effective than the incumbent airline, but still unable to compete with it, (Cairns and Galbraith 1990, pp. 810 - 811).

Furthermore, according to Cairns and Galbraith, if an airline's network is small, some travellers may find it advantageous to become members of more than one programme, since

different networks have different destinations and a small network size may not fit all the traveller's travel needs. Being a member of more than one programme can then be seen as the consumers' way of maximising their overall travel utility.

Cairns and Galbraith reach the following conclusions: 1) An incumbent airline with a large network and a frequent flyer programme has such a strong position on the market that a smaller competitor wanting to enter on one of the incumbent's routes is unable to do so; 2) The incumbent is able - through the programme - to keep prices at a higher than normal level, at the same time keeping new entrants out and thus earning higher than normal profits; 3) If an airline possesses an equal size network as the incumbent, and they both have a programme, the airline is able to stay in the market in competition with the incumbent. However there are no additional profits for either airline as a result of both having a programme.

The paper by Banerjee and Summers reaches the opposite conclusion to Cairns and Galbraith. Banerjee and Summers do not find that the FFPs constitute a barrier to entry. In contrast to Cairns and Galbraith, they assume that all travellers pay full fare. They see FFPs as a form of "contract" between the incumbent and the programme members according to which the incumbent promises to pay out a 'rebate' when the members have accumulated enough bonus points. Thus, having an FFP, makes the incumbent less able to compete with new entrants as the incumbent must honour its FFP obligation to pay out the rebate to its 'hostage customers' who are its programme members.

Banerjee and Summers find that a new entrant without an FFP in a market, where the incumbent is a monopolist with a programme, is able to

capture the entire market, since having an FFP ties down the incumbent. Entry is likely in markets with more than one incumbent all with a programme. Timing the entrance to take place after rebate size is announced by the incumbents ensures successful entry. If entry takes place before the rebate size is announced, entry will most likely fail. In this model, the incumbent's having a programme, signals surrender in that the entrant can enter freely without fear of damaging price wars initiated by the incumbent.

In the situation where two airlines exist in the market and there is no potential entry from a new competitor, it is advantageous for both airlines to have a programme, as it enables them to fix monopoly prices in periods following the introduction of the programme. Contrary to what one might expect, Banerjee and Summers find that this does not lead to sharp price competition in the programme introduction period, since maintenance of (tacit) collusion by both firms charging monopoly prices, requires that both firms have hostage customers both before and after the introduction of the programme.

The conclusions of the two models

With regard to price and welfare effects of FFPs, the two models show that the existence of FFPs increases prices and reduces welfare by: 1) transferring resources from consumers to producers; 2) exacerbating the principal agent relationship. This latter happens because travel spending and monitoring costs of the employers increase.

The models suggest that FFPs increase the survival chance for monopolies and oligopoly market structures in the air transport markets. But where the model of Cairns and Galbraith claims that this is due to the effect of FFPs on entry and the network size of airlines, Banerjee and

Summers regard the effect of FFPs on entry as unimportant and the suggested market structures follow from the contestable market assumption alone. In the model of Cairns and Galbraith one market strategy stands out: airlines should make alliances or merge with existing carriers to increase network size.

5. FFPs and the Applicability of the EC Treaty's Competition Rules

Article 81

The Commission has not published its position on FFPs, but apparently the Commission conducted an unpublished study concerning new entry in air transport, which included an investigation of the effects of FFPs, in June 1992 (referred to in Verchère 1993). According to Verchère, the Commission found that FFPs may act as an anti-competitive method. When FFPs are used as a marketing strategy by larger carriers, the strategy cannot be matched by smaller airlines and they are prevented from competing profitably, (Drabbe 1996, p.3).

The Commission's attitude towards FFPs also emerges in its decisions in a number of different airline partnership agreements and mergers which were investigated by the Commission under article 81(1) and 81(3) or according to the Merger Regulation. In these decisions, the Commission imposes a condition on the alliance for granting an exemption under 81(3) or for permitting the merger, namely that the alliance must offer access to smaller competitors to participate in the merging airlines' FFPs on reasonable and non-discriminatory financial conditions. Both in the BA/TAT and Swissair/Sabena mergers in 1992 and 1995, the Commission limited this obligation to last until a Community regulation concerning FFPs were adopted. This limitation was not mentioned again in the Lufthansa/SAS

partnership agreement, and it seems that in the meantime the Commission has given up its plan to regulate FFPs. But the Commission stated in paragraph 53 of that decision that the

"...pooling of frequent-flyer programmes is....an aspect that must be taken into account in assessing the economic power of the undertakings. Most of the customers are businessmen, and they will clearly prefer airlines that have a joint frequent-flyer programme, allowing them to earn points whatever airline used. A common system is thus likely to constitute a not inconsiderable barrier to other airlines that do not have comparable programmes."

Article 82

Under article 82, Community law does not prohibit large airlines from taking advantage of their networks by exploiting size-related advantages when marketing their service. As long as a particular airline's FFP does not constitute an abuse in the sense of article 82, then difficulties arising for the smaller competitors because the larger airline exploits its network size must be accepted.

So far the neither the Commission nor the ECJ has considered cases involving FFPs in relation to article 82. But both have considered fidelity rebates in the *Hoffmann-La Roche* judgment and target rebates in the *Michelin* judgment. A fidelity rebate is a rebate in which the purchaser explicitly or implicitly undertakes to obtain all or most of his supplies from the same supplier. A target rebate on the other hand is a system whereby the granting of the rebate is conditional upon the attainment of a certain target. The conclusions reached in these decisions may possibly be transferred to FFPs which are a very sophisticated type of rebate system. The ECJ found that fidelity

rebates are different from quantity rebates, quantity rebates being perfectly legal, in that fidelity rebates are designed through the grant of financial advantages, to limit consumer choice between competitors. In that sense fidelity rebates are abusive. In the *Michelin* case the ECJ argued that towards the end of the reference period set for the attainment of the target, the purchaser is under pressure to reach the target or otherwise lose the rebate, thus discouraging the purchaser from choosing freely between different suppliers. Accordingly the target rebate was considered abusive under article 82. Both the fidelity and the target rebates affect adversely the freedom of consumer choice between suppliers, an undesirable result in terms of the desirability of free competition and freedom of consumer choice.

Applying the line of argument of these two judgments to FFPs, the following results are obtained:

1) An FFP can be regarded as a *fidelity rebate*, as it is based on the explicit or implicit condition that the passenger will obtain all or most of his supplies from the airline operating the FFP. As the programmes grant bonuses to the consumer on a non-linear basis, the programme members will find it advantageous to concentrate all their purchases of air transport with one programme holding airline. Thus, membership of a programme will limit the customers' willingness to obtain their supplies of air transport from competing airlines.

2) FFPs may also be considered as a *target rebate*, as the granting of the rebate is conditional upon the attainment of a certain target, for example saving up a certain number of bonus points within a specific reference period in order to obtain a free flight. Particularly towards the end of the

reference period, the passenger is under pressure to reach that target. Many FFPs are designed in this way and accordingly fall within the scope of Article 82. If, as in many of the schemes, the cut-off dates are rolling, i.e. linked in each case to the date on which the points were awarded, the result is less certain. On the other hand, the application of Article 82 seems even more justified in cases where airlines reserve their right to alter the terms of the programme and to introduce new time limits, black-out periods and, indeed, practically to terminate the scheme from day to day, which is indeed a not uncommon procedure practised by some of the programme-holding airlines.

6. Do the Models Agree with the Position of the Commission on FFPs?

Entry

The Commission's attitude is that the pooling of FFPs in connection with an airline alliance is likely to constitute a not inconsiderable barrier to market entry according to Article 81(1). The economic model by Cairns and Galbraith agrees but Banerjee and Summers disagree. The Commission's approach by requiring merging airlines to allow smaller airlines with no FFP to participate in the FFP of the alliance under article 81(3), does ensure market entry according to Cairns and Galbraith. This is due to the fact that the entrant acquires access to the artificial network of the airline alliance, and the switching costs disappear accordingly for programme members when they choose between flying with the alliance or the entrant. Both programme members of the alliance and the entrant's customers get a fair share of the benefit of the alliance as required by article 81(3). Banerjee and Summers regard the effect of FFPs on entry as unimportant and any effects on entry are due to their contestable market assumption.

Price Effects

In its investigation of the partnership agreements of the airlines mentioned above, the Commission seems not to have taken into consideration whether or not the FFPs have any price effects. Both models disagree. Cairns and Galbraith show that the existence of the FFPs and the resulting better utilisation of network size will lead to higher than normal prices. The Commission's position when allowing entrant airlines without FFPs to participate in the programme of the merging airlines allows the merging airlines and the entrant airline to use their combined networks better. This will lead to even higher prices according to Cairns and Galbraith.

As mentioned above, Banerjee and Summers regard the effect of FFPs on entry as unimportant since entrant airlines do not have hostage customers when they enter the market. The Commission's decision with its condition that entrants should be allowed to participate on fair terms in the FFP of the alliance allows entrants to obtain their fair share of hostage customers as a result of participating in the programme of the merging airlines. In accordance with Banerjee and Summers the fact that airlines have hostage customers will reduce their willingness to compete. This again will most certainly lead to higher prices.

Both of these conclusions resemble situations where undertakings with dominant positions are allowed to abuse their dominant position on the market - that is if the conclusions of the models are correct. It might even seem that this abuse is carried out with the Commission's permission.

Market Structure

The above results concerning entry and price effects suggest that airlines will want to enter into bigger and bigger alliances. This is due to the fact

that increasing network size and an increasing number of hostage customers will allow airlines to increase their profits at the same rate as their willingness to compete is reduced. Markets will be more concentrated in this way.

Welfare Effects

The Commission's decision to permit alliances and to allow the members of the alliance to have joint FFPs on condition that entrants are allowed to participate in them is likely to reduce overall social welfare. Those who benefit from the existence of the FFPs and accordingly from the Commission's decision, are the airlines themselves and the business travellers on travel paid for by their employers. The losers will be the employers and the ordinary travellers.

7. Policy Conclusions

All the accessible studies and the economic models described in this article seem to indicate - more or less unanimously - that FFPs create customer loyalty and that this affects adversely market access for new and smaller airlines. Even though the Commission has not taken a position as regards FFPs as such but only in connection with airline alliances, the Commission has at least tried to limit the harmful effects which FFPs are considered to have on market access for competing airlines. However, the Commission has not taken into account the consumer aspect of FFPs, even though lower prices on air fares seem to be indicated, if the Commission were to prohibit or at least regulate the FFPs for the benefit of the consumer. In the following, some proposals for regulating the programmes will be considered.

A Prohibition?

Since FFPs are a worldwide phenomenon it would be unrealistic to suggest prohibiting them unilaterally in the EU. The European airlines themselves argue that a prohibition would damage

or weaken their ability to compete on the world market with foreign airlines – notably the US airlines – who are allowed to use FFPs far more freely. In Denmark FFPs were originally prohibited in the Danish Marketing Practices Act, as they were considered to be illegal collateral gifts. But SAS was able to argue successfully against this prohibition and to persuade the Danish Parliament to exempt FFPs from the prohibition by an amendment of the Act. This happened in 1994. It seems likely that the Commission might be similarly sensitive to this argument and that a prohibition in the EU would in fact not be viable, because it would hamper the European airlines in their bid for survival in the competition with their strong American counterparts. A prohibition might be a realistic option only on the global level and organisations such as WTO or OECD or one of the worldwide air transport associations, such as IATA, might in the long run be the only actors who would be able to eliminate FFPs from the marketing strategies of airlines globally.

Taxation of Bonus Points?

The solution of taxing bonus points is directed primarily against the use which business travellers make of FFPs. It works by reducing the loyalty effects of the programmes. The tax solution has been proposed by the tax authorities of some of the Member States, the Danish, Swedish and the British tax authorities but in fact also by the US tax department, in an attempt to limit the negative effects of the FFPs on competition (Stuart (1997) for the UK and Tievsky (1997) for the US). These attempts came to nothing as the authorities were unable to devise a method by which the value of the bonus points could be calculated and assessed as income for the programme members and which could be made taxable. The solution cannot be implemented on the Community level – at least not yet – because taxation of personal income is

not a subject for Community legislation.

Establishment of a Grey Market for the Selling and Buying of Bonus Points?

A grey market for selling and buying bonus points existed for some time in the US shortly after the FFPs were first introduced in the early 1980s. During this period, bonus points were not registered as belonging to a particular user. The bonus savings could be exchanged or sold on the grey market by brokers who specialised in this. Magazines were published which advertised the offer of bonus points for sale. The annual turnover amounted to over a 100 million USD. This market no longer exists as a result of a number of actions in court which the airlines brought against the brokers and which they subsequently won (Humphries 1991, p. 14).

A grey market for selling and buying of bonus points, is based on the idea that programme members are not getting what they are paying for, because they are unable to accumulate enough bonus points. Travellers who realise that they will be unable to travel the required number of trips in order to reach the target for a free bonus trip, may still benefit from being programme members by selling their bonus savings on the grey market. If bonus points can be sold on the market, more travellers will be able to redeem bonus points and obtain free bonus trips at one time or another. Probably the programmes would also become less attractive for the airlines, but that in itself is not a bad result. Thus the loyalty effects of FFPs will be reduced, and this not by government intervention but simply by making bonus points negotiable on the open (or grey) market.

In practice, this solution is not viable, at least not in the EU, as bonus points are always registered by the airlines under a name and are non-transferable.

A Code of Conduct?

Even though there is a code of conduct for the use of Computer Reservation Systems and for the allocation of slots for landing and take-off as well as laying down guide lines for the use of travel agent commissions (TACOs), the Commission has not made similar rules for the use of FFPs. In the Nordic countries, the Danish, Finnish, Swedish and Norwegian Consumer Ombudsmen have issued joint guidelines for loyalty programmes generally which also cover FFPs. The object of these guidelines is consumer protection and they are only guidelines, i.e. non binding. They prescribe that the FFPs information leaflets should contain information about the cash value of bonus savings and bonus products such as free air travel, free car hire or hotel stays. Such a provision would not greatly influence the use which airlines make of FFPs, as the guidelines do not take the next step of requiring that bonus savings should also be redeemable. If this is not prescribed, the situation arises which is described by Banerjee and Summers as limiting competition: bonus savings do have a cash value but they can only be used within the airline itself.

Our proposal for a code of conduct for the use of FFPs by the airlines in the EU would contain the following elements: 1) a standard of good marketing practice ensuring correct and adequate information about the FFP to the customer so that the customer is able to compare different programmes, their respective advantages and disadvantages. 2) Airlines without a comparable programme should be allowed to join the programmes of existing airlines. 3) Airlines should be required to declare outstanding bonus points on their balance sheets, thus making them legally and financially liable in case of insolvency. 4) The airlines should be required to offer information about the cash value of bonus savings and be

obliged to redeem bonus savings also in those cases where the customer has not saved enough points to obtain a free flight.

This "soft law" solution is the most realistic solution of the ones mentioned. The airlines would probably resist it and the Commission would undoubtedly have an uphill job when trying to introduce it against the protests of the airlines. On the other hand, the solution is technically easy to implement and is not as radical as either the tax solution or the prohibition.

To sum up, it has been shown in this article that there appear to be both entry and price effects in connection with the airlines' marketing of frequent flyer programmes. The Commission appears only to have considered entry effects in connection with article 81 and mergers. As far as we have been able to find out, the Commission has not taken a position according to which the programmes should be regulated. We would suggest that such a position should be reached and should involve the elaboration of a code of conduct with the content indicated above.

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